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E.O. 12958: N/A
TAGS: EFIN EINV CH
SUBJECT: SHANGHAI STOCK MARKET DECLINES: DID THE BUBBLE POP?

REF: A) SHANGHAI 25; B) BEIJING 461

SHANGHAI 00000133 001.2 OF 004

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¶1. (SBU) Summary: The 8.8 percent fall in the Shanghai Stock Exchange (SSE) composite index on February 27 that stunned international markets was a much-needed and overdue correction according to Consulate contacts. Market volatility, speculative retail investors, profit-taking by institutional investors and attempts by the Chinese government to rein in the market's growth all contributed to the market's largest decline in 10 years. Market analysts believe that the market fundamentals are sound and the success in 2006 of stock market reforms and the underlying growth prospects for most stock market-listed companies mean that this correction will not presage a bear market. End summary.

¶2. (SBU) On February 27, the Shanghai Composite Index fell 8.8 percent to close at 2,772. This was the index's biggest decline in ten years, since February 18, 1997 when it fell 8.9 percent. The 8.8 percent fall came the day after the index rose to its all-time high of 3,046 on February 26, having risen 14 percent so far this year. In 2006, the market rose 130 percent (Ref A).

¶3. (SBU) According to SSE Head of International Affairs Li Qian, on February 27, turnover in Shanghai A shares was 128 billion RMB (16.5 billion USD) -- higher than the previous daily record of 108 billion RMB set in January 2006. She said that a total of 835 Shanghai stocks closed lower while 33 actually had gains; more than half of the shares dropped to the 10 percent daily limit allowed by Chinese regulations.

Institutional Selling Triggers Panic...

¶4. (SBU) Li said that the SSE was analyzing the February 27 trading patterns in an attempt to understand what happened. While no conclusions had been reached, she said that SSE consensus was that, after the market broke through the 3,000 point barrier on February 26 for the first time, institutional investors wanted to lock in profits and sold off some of their holdings. She added that fund managers also needed to liquidate some holdings in order to fund dividends on profits from the last quarter that were due in March. This selling prompted "a panic" by retail investors who then rushed to sell off their own holdings. Li told Econoff on February 28 that retail investors would likely sell off a lot of their portfolio in the next two days of trading.

...Rumors Feed the Fire...

¶5. (SBU) Market experts, who spoke with Econoff on February 28, noted that individual Chinese investors were very susceptible to the rumor mill and that this had contributed to the panicked-response to the sell-off of stocks by institutional investors. Haitong Securities Firm Vice Director Wu Bing told Consulate Econ Assistant on February 28 that there were three main rumors that had contributed to the sell-off. These were: the Chinese Security Regulatory Commission's notice that it would crack-down on illegal stock trading; a rumor that the long-awaited stock index futures market would soon open; and a rumor that the government would begin collecting a capital-gains tax on market earnings.

...But Institutional Traders Not Surprised

¶6. (SBU) Lombarda China Fund Management Chief Investment Officer Ian Midgely told Econoff on February 28 that, since market volatility had recently been over 40 percent, the market sell-off was "not really surprising; in fact, it was to be expected." What had been a surprise, he said, was the size of the drop. He noted that, given the speculative nature of most Chinese retail investors, Chinese stock markets were vulnerable to quick pullouts.

¶7. (SBU) In the next couple of days, the market could decline another 10-15 percent, Midgely said, but should not present a serious problem to a market that had risen so high so fast. In the long term, he said, there would be increased flows of institutional money into the market. This would provide a stabilizing effect and the market should not decline further.

¶8. (SBU) Midgely observed, "This is not 2001; the market is fundamentally much more sound. This is not the start of a bear market." He based this analysis on the successful stock market reforms and the fact that the average profit growth forecast for SSE-listed companies was 30 to 40 percent for both 2007 and ¶2008. Midgely said that the market's valuations were good and that he was looking forward to picking up some bargains for the fund he managed.

¶9. (SBU) Other Consulate contacts said:

- "People are worried that there might be more tightening measures taken by the government, such as its aim to crack down on the illegal investments that helped drive benchmarks to

record highs." (Daiwa Asset Management Fund Manager Mono Chung)

- "It's not a bad thing to have a healthy correction since it provides an opportunity to correct over-valuations and allows people who have missed out of the past rally to start buying." (SG Asset Management Chief Investment Officer Winson Fong)

- "This market tumble was unexpected for most retail investors and a snowball chain-reaction led to a free-falling A share market. ... On the other hand, this type of correction provides investors a re-entry point to accumulate undervalued stocks." (Sinopac Securities Research Analyst Sky Hong)

- "Although we didn't forecast the timing or the large size of A share sell-off, the consensus among institutional investors was that a correction would occur after the Chinese New Year. We think that high volatility will carry through the entire year in 2007, but at the end, we believe the A share will have gained further ground from its 2006 surge." (Guotai Junan Asset Management Fund Manager Ruo Lei)

Can You Slow A Bubble Without It Popping?

¶10. (SBU) Beginning in late January, the Chinese government began sounding alarms about the danger of over speculation. In a late January report in the government-controlled China Securities Journal, the China Banking Regulatory Commission (CBRC) issued a circular that warned banks to be on the alert for any personal loans from their clients that might be misused for stock speculation. On February 2, China Central Television (CCTV) broadcast a report, citing an unnamed source at CBRC,

that after the Chinese New Year celebrations (February 19-25), the CBRC would launch a series of country-wide bank inspections. These inspections would focus on banks loan portfolios, and in particular mortgage loans, which had been misused to purchase stocks. The CBRC source said that commercial banks were required to stem the flow of bank loans flowing into stock markets and mutual funds.

¶11. (SBU) The government campaign to cool market speculation continued with the January 25 CCTV broadcast of an interview with James B. Rogers, Jr. (co-founder with George Soros of the Quantum Fund and highly regarded by Chinese investors). Rogers warned that Chinese A shares were overvalued and a bubble was forming. According to a January 25 Financial Times report, Standing Committee of the National People's Congress Vice Chairman Cheng Siwei said that about 70 percent of domestic A-share companies were not worth investing in, and urged individual investors to make rational decisions even in a bull market to ward off risks posed by market bubbles.

¶12. (SBU) On January 26, State-Owned Asset Supervision and Administrative Commission (SASAC) Director Li Rongrong instructed state owned enterprises (SOEs) not to engage in speculation in the share market. (Note: SASAC controlled more than 770 SOEs that are listed on Chinese equity markets. End note.) Li also announced that SASAC would establish an information-sharing process with the Chinese Securities Regulatory Commission (CSRC) to monitor SOE capital flows to make sure that these funds were not entering the equity market.

Just What the Market Needed

¶13. (SBU) Goldman Sachs (China) Chief Representative Xiong Xiong said on February 28 that these warnings had been necessary in order "inject some rationality in an otherwise irrational

market." He saw the February 27 correction as "long overdue" and hoped that the market would not rebound too quickly since such a rebound would "give retail investors even more euphoria and push the market to an even higher extreme." Without a dose of rationality now, the effect of the "ultimate correction would be even more severe," he said. Xiong believed that a further decline of 3-4 percent through the end of trading on March 2 would provide an opportunity for speculative investors to realize the dangers inherent in the stock market.

¶14. (SBU) Xiong's biggest concern was that Chinese officials would overreact to the shock of the correction and begin back-tracking on their statements questioning the soundness of the market's recent gains. He said that he had already heard that this was happening and that officials might back off, or clarify their previous expressions of caution, in days to come.

Stability More Important Than Gains

¶15. (SBU) SSE's Li noted that the Chinese government wanted to have a successful and stable stock market going into the People's Congress in early March. That is why, she said, there were "lots of messages coming out to clarify the rumors that everyone was pointing to." PRC officials were hoping to dispel the rumors in order to promote stability. The government would like to influence the market so that it goes up in the next couple of days. "But the market is a market," she said.

¶16. (SBU) In a separate conversation, Haitong Securities' Wu agreed with Li's assessment. He pointed to the January 19-20 Chinese government financial conference (Ref B) where Premier Wen Jiabao's reportedly said, "Although the stock market performance was very good in 2006, the stock market in 2007 shall be stable." Wu told Econ Assistant that the Chinese securities industry interpreted this remark to mean that, although the central government would like to maintain the bull market, it was more concerned about the risks posed by the speculative bubble. Chinese regulators, according to Wu, needed to find a way to reduce speculation without "completely extinguishing investor enthusiasm."

SSE Doesn't Believe There is a Bubble

¶17. (SBU) In a February 9 discussion about the markets prior to the recent correction, SSE Deputy Director Chao Kejian had told Econoff that the SSE did not actually believe there was much of a bubble. Chao said that the market was very different than it had been in the past and had made many improvements in disseminating market and company information to investors. While he would not, at that time, characterize the market in general as over-inflated, Chao acknowldeged there were "some clearly overvalued stocks."

¶18. (SBU) Commenting on the ups and downs of the stock index since January 1, 2007, Chao said, "The market has its own cycles," and attributed the declines to institutional investors locking in profits from the gains in their blue-chip portfolios. "Blue chips are heavily weighted in the index," and these institutional investors are "refocusing their funds towards mergers and acquisitions of smaller companies.JARRETT